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CHARLES ELMORE CROPLEY
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In the Supreme Court of the United States

OCTOBER TERM, 1943.

No. 840

CLAIRE A. PEKRAS,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent,

and

No. 841

JOHN PEKRAS,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRITS OF CERTIORARI
To the United States Circuit Court of Appeals
For the Sixth Circuit and
BRIEF IN SUPPORT OF PETITION.

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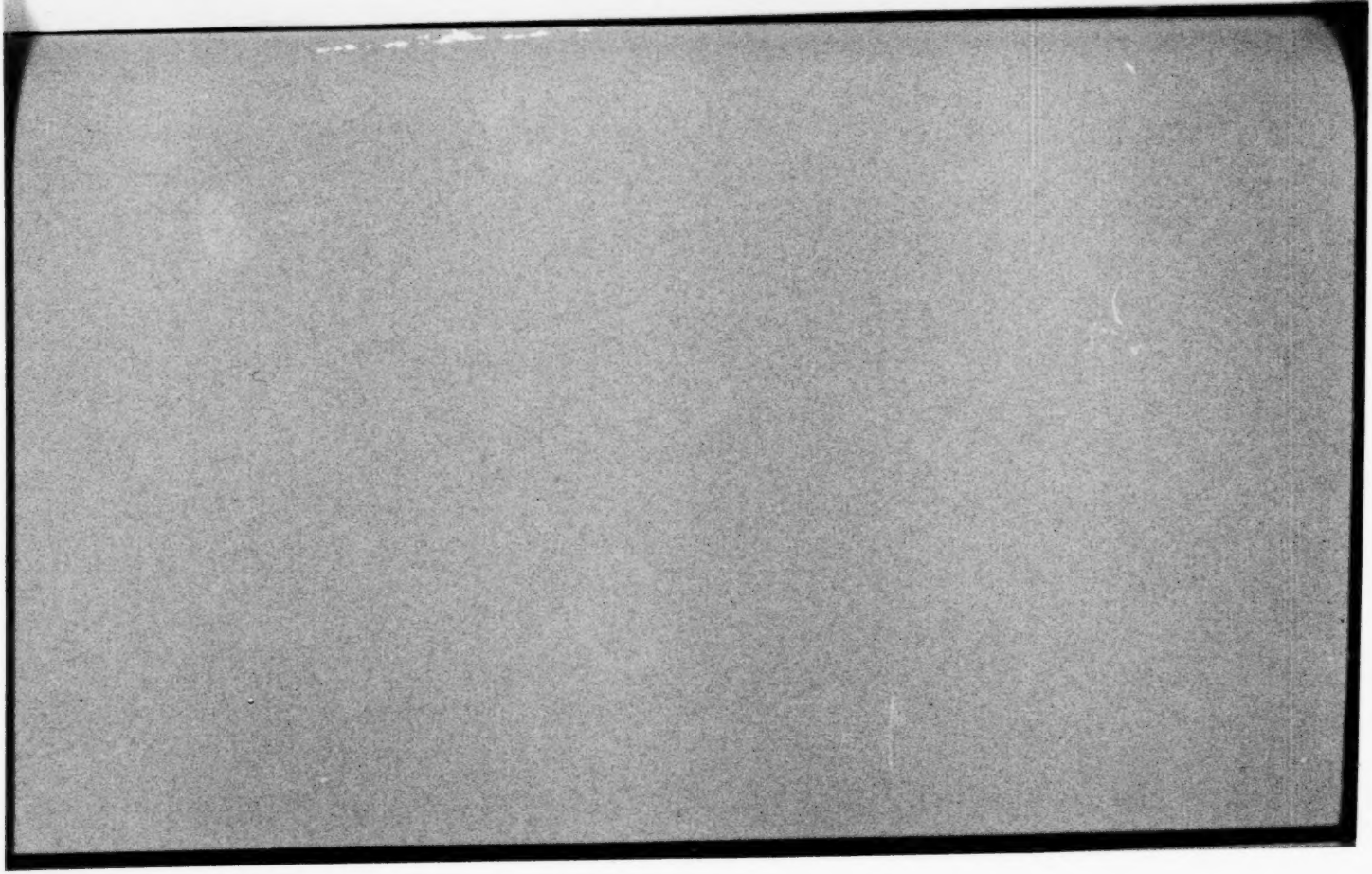

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In the Supreme Court of the United States

OCTOBER TERM, 1943.

No. . . . . . .

CLAIRE A. PEKRAS,

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PETITION FOR WRITS OF CERTIORARI
To the United States Circuit Court of Appeals
For the Sixth Circuit.

To the Honorable, the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

This petition of Claire A. Pekras and John Pekras, petitioners, respectfully shows unto this Honorable Court:

A.

Summary Statement of Matter Involved.

These two cases originated in The Tax Court of the United States. They were submitted to that Court on joint stipulation and decided, adversely to petitioners, in a single Memorandum Opinion. They were argued together before the United States Circuit Court of Appeals for the Sixth Circuit. By joint order the ruling of The Tax Court was affirmed without detailed opinion. A joint Petition for Rehearing was filed and overruled by said Circuit Court of Appeals, likewise without opinion.

Hence these cases are separately docketed but this joint petition is filed.

These cases contest deficiency assessments of income taxes for 1940. In that year petitioners sold their interests in certain motion picture theatres in Elyria, Ohio.

Petitioner, Claire A. Pekras, owning the Capitol Theatre, sold (1) her Building Rights and Equipment for $75,000, and (2) her leasehold for $105,000.

Petitioner, John Pekras, sold (1) his future lease of New Rivoli Theatre for $49,000, (2) his Building Rights and Equipment of Lincoln Theatre for $20,000 and, (3) his leasehold covering the Lincoln Theatre site for $60,000.

Since neither petitioner had any capital investment in any one of these three leases recoverable, while owned by them, in whole or part by means of any income tax allowance or deduction; and since the Treasury Regulations have for years provided, and still do provide, that any recovery by a lessee of capital invested in a lease shall be had under Section 23(a), Internal Revenue Code, as a form of rental expense, rather than under Section 23(l) as depreciation; both petitioners reported their profit from sale of these leases as long-term capital gains, only 50% thereof being taxable under Section 117(b), Internal Revenue Code.

Respondent contends such leaseholds are not capital assets under Sec. 117(a)(1), Internal Revenue Code, and that the said gains are ordinary income and 100% taxable. The assessments here contested reflect such contention.

The Tax Court supported its decision by a conclusion of fact directly contrary to the facts stipulated by the parties and expressly found by that Court.

B.

Opinions and Records, Below.

The Memorandum Opinion of The Tax Court is reprinted in full in the Record. (C. A. P. Rec. pp. 22-26).

The order of the Circuit Court of Appeals appears in full in the Record. (C. A. P. Rec. p. 35; J. P. Rec. p. 19.)

The joint Stipulation of Facts and Tax Court Opinion were included only in the Claire A. Pekras case Record. References to that Record are identified as "C. A. P. Rec.," while references to the John Pekras case Record are identified as "J. P. Rec."

C.

Statement of Basis of Jurisdiction.

Both petitioners filed their petitions with the Board of Tax Appeals, now the Tax Court, that of Claire A. Pekras being No. 112,359 and that of John Pekras being No. 112,360 on the docket of that Court. The two cases were submitted on joint stipulation (C. A. P. Rec. pp. 14-22), and decided by one Memorandum Opinion, the full text of which is found in Claire A. Pekras Record, pp. 22-26, entered May 31, 1943. (C. A. P. Rec. p. 27.)

Petitions for Review were duly filed in the United States Circuit Court of Appeals for the Sixth Circuit, that of Claire A. Pekras being in case No. 9612 and that of John Pekras being in case No. 9613, on the docket of that Court. The two cases were argued together on Dec. 10,

1943 and on Dec. 16, 1943 an order affirming the ruling of the Tax Court was entered. (C. A. P. Rec. p. 35; J. P. Rec. p. 19.) Petition for Rehearing (C. A. P. Rec. pp. 39-50; J. P. Rec. pp. 23-34) was filed Jan. 6, 1944 and denied, without opinion, Feb. 23, 1944. (C. A. P. Rec. p. 51; J. P. Rec. p. 35.)

The jurisdiction of this Honorable Court is invoked under Title 28, Section 347, paragraph (a), United States Code (Judicial Code, section 240, as amended).

D.

The Questions Presented.

The ultimate question presented is:

What is the proper construction and true meaning of the following language in Sec. 117(a)(1) of Internal Revenue Code:

> "The term 'capital assets' * * * does not include * * * property * * * of a character which is subject to the allowance for depreciation provided in section 23(l) * * *."

The Records in these cases present, as incident to the solution of that ultimate question, four specific questions.

One. Is a leasehold interest in lands, as distinguished from interests in buildings on such lands and equipment in those buildings, property of a character which is subject to the specific allowance for depreciation provided by Section 23(l), Internal Revenue Code?

Two. Is such a leasehold, as to which no recovery of capital investment could have been had, at any time while the taxpayer owned it, by means of any income tax allowance for, in lieu of, or in the nature of depreciation property; of a character which is subject to the specific statutory allowance for depreciation?

Three. Shall a policy of taxpayer entrapment, by resort to interpretations contrary to its Regulations, indulged

in by the Bureau of Internal Revenue, be approved, without opinion, as the law of the land?

Four. Is a conclusion of the Tax Court, contrary to its own express findings of stipulated facts, binding upon reviewing courts?

E.

Reasons for Allowance of the Writs.

We believe the discretion of this Honorable Court will dictate the allowance of the requested Writs of Certiorari, for the reasons:

I. That the Circuit Court of Appeals for the Sixth Circuit has in these cases decided an important question of federal law, namely, the interpretation of Internal Revenue Code, Section 117(a)(1), which question has not been, but should be, settled by this Honorable Court.

II. That the said Circuit Court of Appeals, by affirming the Tax Court in these cases, decided such question of federal law in a way probably in conflict with applicable decisions of this Honorable Court, in that:

Such decision in effect holds that any leasehold, whether it covers land only, buildings only, or lands and buildings, and regardless of whether or not there is a capital investment therein, is depreciable property. Such holding is erroneous since:

(a) It fails to give effect to the words "is subject" and "the allowance" in Section 117(a)(1), Internal Revenue Code.

(b) It ignores the lawfully required allocation of cost and sale price to lands and improvements thereon separately.

(c) It ignores the rule that lands or interests therein are not depreciable and the further rule that it is only the capital investment, not value, which is recoverable by a taxpayer lessee by means of any income tax deduction.

III. Respondent has by long continued Regulations instructed taxpayers that any recovery by lessees of capital investment in leaseholds is under Section 23(a), as a form of rental expense, rather than under Section 23(l), as depreciation. After these petitioners, in determining the advisability of making these sales, had relied on such Regulations, the Respondent adopted a construction contrary to those Regulations and assessed the deficiencies herein contested.

Shall such deliberate taxpayer entrapment be judicially approved?

IV. In these cases the Tax Court, after making specific findings of stipulated facts, bases its conclusion upon factual statements directly contrary to such prior findings. By denying our Petition for Rehearing the Circuit Court of Appeals refused to review such factual inaccuracy specifically pointed out therein. (C. A. P. Rec. p. 45; J. P. Rec. p. 29.)

Shall conclusions of fact, essential to its decision, found by any trier of facts, be conclusive upon reviewing courts when obviously untrue and against the manifest weight of the evidence?

In support of the foregoing grounds of application for these writs of Certiorari petitioners submit the accompanying brief.

WHEREFORE, your petitioners respectfully pray that writs of certiorari be issued out of and under the seal of this Court directed to the United States Circuit Court of Appeals for the Sixth Circuit, commanding that Court to certify and send to this Court, on a day certain to be named therein, a full and complete transcript of the records of the proceedings in the cases numbered and entitled on its docket as "No. 9612, *Claire A. Pekras, Petitioner, vs. Commissioner of Internal Revenue, Respondent,*" and "No. 9613, *John Pekras, Petitioner, vs. Commissioner of Internal Revenue, Respondent,*" to the end that the said causes may

be reviewed and determined by this Court as provided by law; that the judgments in said cases may be reversed with costs; and for such other and further relief as may be appropriately granted in the premises.

ROBERT H. RICE,

Counsel for Petitioners.

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CLAIRE A. PEKRAS,

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JOHN PEKRAS,

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF OF PETITIONERS IN SUPPORT OF PETITION FOR WRITS OF CERTIORARI.

In support of the joint Petition for Writs of Certiorari, we submit this brief setting out our reasons for believing these three leases sold by these petitioners on May 1, 1940, were capital assets within the meaning of Section 117(a) (1), Internal Revenue Code.

SUMMARY DISCUSSION OF FACTS.

I. AS TO CLAIRE A. PEKRAS CASE.

She acquired this lease of land, title to the Capitol Theatre buildings thereon subject to reversionary rights of the lessor, and full ownership of the theatre equipment, for a lump sum in 1934. (C. A. P. Rec. pp. 15, 18.)

In 1934 there was no reason, tax-wise or otherwise, for making any allocation of costs to the separate items covered by her purchase contract. Actually the lease cost her nothing. It was to be modified as to rentals and extended as to term. (C. A. P. Rec. p. 22.) At the rental, before modification, the lease was recognized by buyer and seller as a liability to be assumed rather than an asset to be purchased. Accordingly she set up on her records her entire payment as cost of buildings and equipment. (C. A. P., Rec. pp. 19, 20.)

On her income tax returns for years 1935 through 1939, she claimed, and Respondent allowed, a deduction in lieu of depreciation, under Regulations 103, Sec. 19.23(a)-10, based on that cost of buildings and equipment. (C. A. P. Rec. p. 24.)

She sold the buildings and equipment at a profit. No question is involved here as to that. At the same time she specifically sold the lease for $105,000. (C. A. P. Rec. p. 25.)

II. AS TO JOHN PEKRAS CASE.

In 1937 he acquired the New Rivoli lease, for the term of twenty-five years starting January 1, 1941. (C. A. P. Rec. pp. 16, 25.) He paid nothing to the lessors therefor. (C. A. P. Rec. p. 21.) To protect his title under that lease he did, thereafter, pay $4,500 to acquire outstanding adverse interests. That sum he capitalized, but claimed no recovery thereof as an income tax deduction since the term of that lease did not begin until eight (8) months after he sold it. (C. A. P. Rec. pp. 21, 25.)

In 1932 he acquired the Lincoln lease for the term of twenty-five years starting Jan. 1, 1933. He paid nothing for it. (C. A. P. Rec. p. 25.)

Thus he acquired both leases prior to the beginning of their terms. He paid nothing to either lessor therefor. Yet after expressly finding those stipulated facts, the Tax Court, in the final paragraph of its Opinion, makes this amazing statement:

> "The leaseholds that petitioners sold were acquired by purchase during their fixed terms." (C. A. P. Rec. p. 26.)

III. AS TO BOTH CASES.

Payments by the purchaser were spread over a ten year period. From the payments received in 1940 and 1941 petitioners reported their gains from sales of buildings and equipment as ordinary income. Their gains from sales of these leases were reported as long-term gains from sales of capital assets, 50% taxable.

Respondent assessed the deficiencies on his contention that these leases were not capital assets and that the gains from sales thereof were ordinary income, 100% taxable.

The case of Claire A. Pekras involves a claimed income tax deficiency of the year 1940 of $3,469.32. (C. A. P. Rec. p. 11) and, by mutual understanding, also determines liability as to a similar claimed deficiency for 1941 of $6,424.90.

The case of John Pekras involves a claimed income tax deficiency for the year 1940 of $4,158.06 (J. P. Rec. p. 10) and, by mutual understanding, also determines liability as to a similar claimed deficiency for 1941 of $7,198.76.

ERRORS ASSIGNED.

There is error manifest on the face of the Records in these cases in this, to-wit:

I. Said Tax Court and said Circuit Court of Appeals erred in construing the language of Sec. 117(a)(1), Internal Revenue Code, which reads:

"property * * * of a character which is subject to the allowance for depreciation provided in section 23 (l) * * *,"

as if that language was, instead:

> property * * * of a character which under other circumstances might be subject to any allowance for, in lieu of, or in the nature of, depreciation under any section of the Internal Revenue Code.

II. The said Courts erred in sustaining a contention of Respondent directly contrary to his Regulations issued for guidance of taxpayers and effective for over twenty years, thereby approving a policy of deliberate taxpayer entrapment.

III. Said Circuit Court of Appeals erred in adopting as binding upon it a conclusion of fact stated by the Tax Court, directly contrary to facts stipulated by the parties and expressly found by the Tax Court earlier in its Opinion.

IV. Said Circuit Court of Appeals erred in affirming the decision of the Tax Court and in denying our Petition for Rehearing.

REASONS FOR ALLOWANCE OF THE WRITS.

I. So far as we can learn, the question of the proper interpretation of this portion of Section 117(a)(1), Internal Revenue Code, has never been presented to or decided by this Honorable Court. Affecting as it does all intangible property used in business, it is a question of great general interest to taxpayers and tax collecting authorities. We feel that it is of sufficient importance to merit consideration and final determination by this Honorable Court.

II. The said Circuit Court of Appeals, in affirming the Tax Court, decided this question of federal law in a way probably in conflict with applicable decisions of this Honorable Court for reasons pointed out in our Argument herein.

III. Does not a construction of this statute by Respondent which is directly contrary to his long standing Regulations issued for guidance of, and relied upon by, taxpayers, constitute taxpayer entrapment which should be judicially disapproved?

IV. Shall conclusions of fact, found by any trier of facts, be conclusive on reviewing courts when obviously untrue and contrary to all the evidence?

We cannot but believe that the decision of this Honorable Court in *Dobson vs. Commissioner of Internal Revenue*, Nos. 44 and 47, decided Dec. 20, 1943, reported in Vol. 88 (Advance Sheets), Law Ed. p. 179, impelled the Circuit Court of Appeals to deny our Petition for Rehearing and thereby refuse to consider the obvious error of the Tax Court pointed out therein. (C. A. P. Rec. p. 45; J. P. Rec. p. 29.)

We do not believe this Honorable Court intended to, or did, announce such rule in said *Dobson* case. We do believe that this Circuit Court of Appeals acted on the assumption that Your Honors had announced that rule. We believe these cases present the logical opportunity to define the intended limits of the *Dobson* case rule.

SUMMARY OF ARGUMENT.

As to the questions presented and errors assigned our contentions are:

I. These leaseholds are not within the definition of non capital assets given in Section 117(a)(1), Internal Revenue Code, because:

A. The statute should be construed so as to give effect to the words "*is* subject" and "*the* allowance" used therein.

B. A leasehold as it relates to land, distinguished from tangible property on that land, is not subject to "the allowance for depreciation provided in section 23(l)," since:

1. Such allocation between land and tangible physical property on that land is proper.

2. Such interest in land is not depreciable, in any sense of that term, in the absence of present loss of capital investment therein.

II. Respondent having by Regulations provided that any such allowance to a lessee is under Section 23(a), Internal Revenue Code, should not now be permitted to claim it is under Section 23(l). Such reversal of position constitutes deliberate taxpayer entrapment.

III. A conclusion of the Tax Court, contrary to facts stipulated and found, is not binding upon and should not be adopted and followed by reviewing courts.

ARGUMENT.

I. THESE LEASEHOLDS ARE NOT WITHIN THE DEFINITION OF NON CAPITAL ASSETS GIVEN IN SEC. 117(a)(1), INTERNAL REVENUE CODE, BECAUSE:

A. The statute should be construed so as to give effect to the words "is subject" and "the allowance" used therein.

The statute reads:

"The term 'capital assets' * * * does not include * * * property * * * of a character which is subject to the allowance for depreciation provided in section 23(l) * * *."

The ruling of the Tax Court, affirmed by the Circuit Court of Appeals, amounts to just this:

That any leasehold, regardless of whether or not there was any capital investment in it, regardless of the term of the lease, is property subject to the statutory allowance (Sec. 23(l), Internal Revenue Code) for depreciation.

That ruling interprets the statute as if it read:

Property * * * of a character which *might be*, under other circumstances or at a later date, *subject* to *any allowance in the nature of* depreciation.

We believe the statute should be construed so as to give effect to the words "*is* subject" and "*the* allowance."

> "It is a cardinal rule of statutory construction that significance and effect shall, if possible, be accorded to every word."
>
> *Market Co. v. Hoffman,* 101 U. S. 112 at 115.

The courts below ignored that rule.

We believe the statute in defining "character" of the property sets up two essential elements; (1) that it be currently subject to an allowance, and (2) that it be subject to the specific statutory allowance. The leases sold by petitioners lacked both of these elements.

B. A leasehold, as it relates to land, distinguished from tangible property on that land, is not subject to "the allowance for depreciation provided in section 23(l)," since:

1. Such allocation between land and tangible physical property on that land is proper.

Congress recognized that this exclusion of certain property from "capital assets" did not apply to land.

> "For example, if an apartment house is sold, under the present law, it is necessary to separate the land from the building for income tax purposes."
>
> Committee Report on the Revenue Bill of 1942;
> House of Representatives Report No. 2333;
> Int. Rev. Cum. Bull. 1942-2, p. 414, par. 21.

Respondent expressly stated that it had no application "to the extent that such gain or loss is allocable to the land, as distinguished from depreciable improvements on the land." Regulations 103, Sec. 19.117-1.

Congress recognized the necessity for, and Respondent required, such allocation. On these sales both petitioners and the purchaser made such allocation. (C. A. P. Rec. p. 25.) Now Respondent seeks to deny effect thereto.

The petitioners and the purchaser definitely fixed $105,000, $60,000 and $49,000 as the price for the respective leases, in addition to the prices fixed for buildings and equipment. Such prices were not extra payments for the tangible physical property. Rather they were definite allocations, by both buyer and seller, of a specific value to these interests in land, to the right to use these lands as sites for these theatres for a definite term of years.

The rulings of the courts below refuse effect to the allocations so made and thereby defeat Congressional intent and nullify the Treasury Regulations.

And that in face of the fact that these leases are interests in land.

In Ohio a lease constitutes "a sale of an interest in real estate."

Brenner, et al. v. Spiegle, 116 Ohio State 631.

An Ohio land trust certificate is an interest in land and taxes imposed thereon are taxes on land.

Senior v. Braden, et al., 295 U. S. 422.

Since a tax on an interest in land is a tax on land, how can it be held that a profit from sale of an interest in land is not profit from a sale of land?

Yet the courts below have held the profit from these sales of these interests in land to be profit from the sale of property subject to the statutory allowance for depreciation.

2. Such interest in land is not depreciable, in any sense of that term, in the absence of present loss of capital invested therein.

The only possible reason for the statute removing depreciable property from the "capital asset" classification, is that through the depreciation allowance the owner has recovered part of his capital investment. His base for determining profit or loss in event of sale has changed. If there has been no capital investment, or no part of any

investment has been recovered or is legally recoverable, there is no reason or excuse for the distinction. Yet taxation is supposed to be a practical matter. *Harrison v. Schaffner,* 312 U. S. 579 at 582.

In *Weiss v. Wiener,* 279 U. S. 333, where this same Circuit Court of Appeals was once before in error as to depreciation, Mr. Justice Holmes, referring to a lessee, said:

> "Of course, he must show an interest in the property and a present loss to him to make the statute apply." p. 336.

If the statute does not "apply," how can the property be currently subject to it?

The history of the case relied on by the Respondent and the Tax Court, when compared with these cases, is illuminating.

Eighteen months after these petitioners sold these leases the Board of Tax Appeals, on Nov. 14, 1941, decided *Fackler v. Commissioner,* 45 B. T. A. No. 115. It held the Fackler lease was not a capital asset. That was the first time this question had been judicially determined. Thereupon Respondent first raised the issue as to petitioners. This same Circuit Court of Appeals affirmed the Board. *Fackler v. Commissioner,* 133 Fed. (2d) 509.

That case is clearly distinguishable from these cases.

There Fackler had established a cost for his leasehold interest in land and buildings as a unit. He had claimed depreciation. Here petitioners had no investment in their interests in lands recoverable in any part while they owned such interests. There Fackler made no allocation on the sale of any part of the selling price to the interest in land apart from the interest in buildings. Here such specific allocation was made. There no question as to interpretation of the statute was raised, no issue as to the Regulations was presented. Here such question and issue, duly raised, were ignored.

When our case came before the Tax Court they brushed aside all issues distinguishing features of our cases, saying:

> "Generally speaking, a leasehold is of such character" (i.e. subject to depreciation), "(*Fackler v. Commissioner*, 133 Fed. (2d) 509), * * *." (C. A. P. Rec. p. 26.)

The Circuit Court of Appeals in its *Fackler* opinion, 133 Fed. (2d) 509, relied on *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. 252. And remarks by Judge Allen during argument of these cases clearly indicated that she, at least, was still relying on that case as holding all leaseholds to be depreciable property.

But in *Helvering v. F. & R. Lazarus & Co.*, 308 U. S. 252, this Honorable Court did not so decide. This Court did not even intimate that every leasehold, or even that "generally speaking" a leasehold, is depreciable property. Rather this Honorable Court sustained the lower courts in treating a nominal leasehold as an actual fee. There the taxpayer had ostensibly sold the property to a trustee; the trustee had sold land trust certificates and given back to taxpayer a lease. If it was a lease, then lessee had no capital invested in it. But Your Honors held that in reality the transaction was a pledge of the property as security for a loan. Accordingly Lazarus & Co. was, in truth, the owner with a capital investment in lands and buildings as to which it was sustaining a current loss, allowable as an income tax deduction.

Far from holding that every leasehold is depreciable property, as the Tax Court and the Circuit Court of Appeals imply, this Honorable Court there clearly recognized the rule, here contended for by petitioners, that a leasehold in which a lessee has no capital investment as to which a current loss is sustained is not depreciable property.

Weiss v. Wiener, supra, and *Helvering v. F. & R. Lazarus & Co., supra,* establish that for income tax purposes all leaseholds may be divided into two classes:

One. Those of a character subject to the statutory allowance for depreciation, or a rental expense allowance in lieu thereof. The essential element of that character being a capital investment by lessee as to which a present loss is sustained.

Two. Those of a character not subject to any such allowance. The essential element of that character being no present loss of capital investment.

The courts below ignored that distinction.

II. RESPONDENT HAVING BY LONG CONTINUED REGULATIONS PROVIDED THAT THE ONLY ALLOWANCE TO LESSEES IN LIEU OF, OR IN THE NATURE OF, DEPRECIATION IS UNDER SECTION 23(a), INTERNAL REVENUE CODE, SHOULD NOT NOW BE PERMITTED TO CLAIM IT IS UNDER SECTION 23(l).

Such reversal of position, without change of Regulations, constitutes deliberate taxpayer entrapment.

This Honorable Court has said:

> "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes are deemed to have received congressional approval and have the effect of law."
>
> *Helvering v. Winmill,* 305 U. S. 79 at 83.

Treasury Regulations No. 103 were in effect when these petitioners made these sales. As taxpayers they were told how to use them.

> Reg. 103. *Explanation of Regulations.* * * * "By use of these key numbers one can readily ascertain how a given section, subsection, or paragraph of the Internal Revenue Code has been interpreted by the Bureau. Thus, one desiring to learn what interpreta-

tion has been placed on section 23(d) of the Code should turn to section 19.23(d)-1 of the regulations. * * *"

Pursuant to such instructions we turn to Section 19.23(l) to find how Section 23(l) of the Code has been interpreted. We find therein not one word relating to deduction of depreciation by a lessee.

But under Section 19.23(a)-10 we find:

"Sec. 19.23(a)-10. *Rentals.* If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. * * * The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of the lease, and such deduction shall be *in lieu of* a deduction for depreciation. * * *" (Emphasis ours.)

Similar provisions have appeared in each issue of the Regulations since Reg. 62 issued in 1921, and appear without change in Reg. 111, Sec. 29.23(a)-10, issued Oct. 26, 1943, while these cases were pending in the Circuit Court. They have stood without material change as the announced policy of Respondent for twenty-three years.

They must have embodied the interpretation Congress intended in specifying this particular Section 23(l) in the revision of Sec. 117(a)(1).

Throughout the years since 1921 Respondent has, by these Regulations, denied to lessees the allowance under Section 23(l). Throughout those years Respondent has, by those Regulations, granted lessees a rental expense deduction "in lieu of" that statutory allowance, under a different section, namely, Section 23(a).

Now when these petitioners have relied and acted on those Regulations the Respondent seeks to change his interpretation. Is there no obligation of consistency on him? *Virginian Hotel Corp. v. Helvering*, 319 U. S. 523, dissent of Mr. Justice Jackson, pp. 531-532. Yet even while Respondent seeks to enforce this new interpretation, he reissues the original interpretation in Regulations No. 111.

If that is not deliberate taxpayer entrapment we know not what to call it.

Under what theory of statutory construction can an allowance "in lieu of" a specified allowance be held to be "the" specified allowance itself? The lower courts have refused to answer that question. We submit it merits an answer.

III. A CONCLUSION OF THE TAX COURT, CONTRARY TO FACTS STIPULATED AND FOUND, IS NOT BINDING UPON AND SHOULD NOT BE ADOPTED AND FOLLOWED BY REVIEWING COURTS.

As pointed out in the foregoing discussion of facts as to the John Pekras case, the parties stipulated and the Tax Court found in the early portion of its Opinion:

That John Pekras paid nothing for either lease when he acquired them. He acquired both prior to the beginning of their respective terms. Yet the Tax Court concludes:

> "The leaseholds that petitioners sold were acquired by purchase during their fixed terms." (C. A. P. Rec. p. 26.)

That statement is partially true as to the Capitol lease sold by Claire A. Pekras. But as to the two leases sold by John Pekras it is absolutely untrue.

If the matters of statutory construction and the effect of the Regulations be ignored that conclusion does support the decision in the Claire A. Pekras case. The evidence being not conclusive the Tax Court's finding should be binding.

But as to the John Pekras case, the undisputed fact is that he had no recoverable capital investment in either lease he sold. The decision in his case can be supported only if this false conclusion be taken as not subject to review. The obvious falsity of that conclusion distinguishes the John Pekras case from the Claire A. Pekras case. The lower courts ignored that distinction.

CONCLUSION.

We therefore believe these cases merit the exercise by this Honorable Court of its supervisory authority so that the errors complained of may be corrected. We believe that, accordingly, the writs of certiorari should be granted, the issues reviewed and determined and the decisions of the Circuit Court of Appeals reversed.

Respectfully submitted,

R. H. RICE,

Counsel for Petitioners.

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CITATIONS

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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 840

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COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The memorandum opinion of the Tax Court of the United States (No. 840, R. 22–26) is unreported. The Circuit Court of Appeals affirmed the decisions of the Tax Court without opinion (No. 840, R. 35; No. 841, R. 19).

JURISDICTION

The judgments of the Circuit Court of Appeals were entered on December 16, 1943. (No. 840, R. 35; No. 841, R. 19.) Petitions for rehearing were denied on February 23, 1944 (No. 840, R. 51; No. 841, R. 35). A joint petition for writs of certiorari was filed in this Court on April 3, 1944. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Is a leasehold property of a character which is subject to the allowance for depreciation provided in Section 23 (l) of the Internal Revenue Code so that it is not a "capital asset" within the meaning of Section 117 (a) (1) of the Internal Revenue Code?

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations are set out in the Appendix, *infra*, pp. 12–14.

STATEMENT

1. In the case of Claire A. Pekras, wife of John Pekras, the facts as stipulated (R. 14–22) and as found by the Tax Court (R. 22–24) may be summarized as follows:

One Ely, the owner of certain land, leased it in 1920 to Sadaris for a term expiring September 30,

1945. Under the agreement the lessee erected the Capitol Theater which, on expiration of the lease, was to revert to the lessor. The term of the lease was later extended to September 30, 1955. In 1930, the interest in the lease, theater building and equipment was bought by Warner Bros. Pictures, Inc. On November 23, 1934, the original lease, the first extension and all personal property, furniture, and equipment in the theater was sold to the taxpayer, Mrs. Pekras. (R. 18–19, 23.)

As part of the consideration for the sale the taxpayer cancelled the balance of unpaid rent due her under the lease from Warner Bros. Pictures, Inc., in the amount of $22,565.16; she assumed and paid the balance of unpaid rent due to Sadaris from Warner Bros. Pictures, Inc., in the amount of $11,934.72; and paid Warner Bros. Pictures, Inc., $25,000 in weekly installments of $100, making a lump sum purchase price or cost of $59,499.88 (R. 18, 23).

While the sale of November 23, 1934, was being negotiated, the taxpayer on August 30, 1934, obtained from Ely an additional extension of the term of the lease to September 30, 1959. She paid $1,500 attorneys' fees for services in connection with negotiations with Ely for extension of the lease and in other legal matters connected with the theater and allocated $1,400 of this fee to services in connection with the lease. This $1,400 was deducted by her and allowed by the Commissioner as an ordinary and necessary business

expense in 1934. It was again set up in her return for 1940 as cost of the leasehold. (R. 19, 23–24.)

In 1940 the taxpayer owned the lease running to September 30, 1959, the building, subject to the reversionary interest of Ely, owner of the fee, and full title to all furnishings and equipment of the theater (R. 15). On May 1, 1940, these were sold to Edith Amster for $180,000, $105,000 being allocated in the agreement for the lease and $75,000 for the equipment and building rights. In 1940 she received $26,850 on the sale price of $105,000 for the lease, of which $23,807.08 was profit. She reported 50% of the profit as taxable gain on the sale of a capital asset (R. 20, 25) under Section 117 (b) of the Internal Revenue Code (Appendix, *infra*).

The Commissioner taxed the entire profit as an ordinary gain (R. 10–11), and determined a deficiency in income tax for the year 1940 of $3,469.32 (R. 9) which the Tax Court sustained (R. 27). The Circuit Court of Appeals affirmed (R. 35).

2. In the case of John Pekras, husband of Claire A. Pekras, the facts as stipulated (No. 840, R. 14–22) and as found by the Tax Court (No. 840, R. 24–25) may be summarized as follows:

In 1913 certain land was leased by the owner to Dachtler & Dachtler for a term expiring in November 1933, later extended to January 1, 1941.

In 1915, the land was sublet to one Bannon for the unexpired term and the erection of a theater. In 1922–1923, the New Rivoli Theater was erected on the premises by the sublessee. In 1922 Bannon assigned his interest in the lease to The Bannon Theatre Company. The lease provided that building improvements would revert to the owner of the fee on expiration of the term on January 1, 1941. John and Claire Pekras owned the majority of the shares of The Bannon Theatre Company. (No. 840, R. 24.)

In 1937 the fee owners leased the premises to John Pekras for a term January 1, 1941, to December 31, 1965. He paid $4,500 to acquire outstanding adverse interests. In April 1940, The Bannon Theatre Company was the owner of the lease and owned the theater building, subject to the rights of the fee owners, and had full title to the theater equipment. The $4,500 was capitalized by John Pekras but no amortization thereon was claimed in his 1937, 1938 or 1939 tax returns. (No. 840, R. 25.)

In 1922 John Pekras became the lessee of part of a three-story building, including the Lincoln Theater, for a term ending August 31, 1937. In 1932 a new lease was made for a term expiring December 31, 1958, later changed to December 31, 1957. No consideration was paid for this lease beyond annual rental. In April 1940, John Pekras owned the lease expiring December 31, 1957, all furnishings and equipment in the theater,

and the right to use building alterations and improvements made by him for the term of the lease. His unamortized cost of the equipment was $18,643.87. (No. 840, R. 25.)

On May 1, 1940, John Pekras and The Bannon Theatre Company sold their respective interests to Edith Amster, giving separate leases for the unexpired terms and separate bills of sale of the equipment in the theaters. The entire sale price of $49,000 for the New Rivoli Theater was for the lease alone. Of that amount John Pekras received $12,525 in 1940, of which $10,112.10 was profit. The sale price of the Lincoln Theater was allocated $60,000 for the lease and $20,000 for the equipment and building rights. Of that amount John Pekras received $15,339 in 1940, of which $13,794.56 was profit. (No. 840, R. 25.) He reported 50% of the profit as taxable gain on the sale of a capital asset (No. 841, R. 9) under Section 117 (a) (1) of the Internal Revenue Code.

The Commissioner taxed the entire profit as an ordinary gain (No. 841, R. 9) and determined a deficiency in income tax for the year 1940 of $4,158.06 (No. 841, R. 8) which the Tax Court sustained (No. 841, R. 12). The Circuit Court of Appeals affirmed (No. 841, R. 19).

ARGUMENT

There is no conflict of decisions and none is pointed out by the petitioners. The decisions be-

low are plainly correct, and further review by this Court is unnecessary.

1. Petitioners claim that their sales of the leases constitute sales of capital assets, and that, accordingly, under Section 117 (b) they are taxable only upon 50% of the gain realized. But "capital assets" are so defined in Section 117 (a) (1) as to exclude "property, used in the trade or business, *of a character* which is subject to the allowance for depreciation provided in Section 23 (l)." [Italics supplied.] Section 23 (l) (Appendix, *infra*) grants a "reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence." This allowance is customarily referred to as "depreciation."[1]

Many cases now establish that a leasehold is subject to an allowance for depreciation or exhaustion over the term of the lease. *Kaufman-Straus Co.* v. *Lucas,* 12 F. 2d 774 (C. C. A. 6th); *Fackler* v. *Commissioner,* 133 F. 2d 509 (C. C. A. 6th); *Bonwit Teller & Co.* v. *Commissioner,* 53 F. 2d 381,

[1] The statute uses the word "depreciation" and describes it as including "exhaustion." While as a matter of practice the word "amortization" is frequently used to describe the annual loss in value of a contract or lease, it is not used in the technical sense but as representing exhaustion over a fixed period of time. It is significant that depreciation of leaseholds and court decisions relating thereto are treated under Section 23 (l) in Commerce Clearing House Federal Tax Service (1944), Vol. I, par. 216, pp. 1770–1773. That has also been the practice in the past.

383–384 (C. C. A. 2d), certiorari denied, 284 U. S. 690; *Davison* v. *Commissioner,* 60 F. 2d 50, 52 (C. A. A. 2d); *Helvering* v. *Lazarus & Co.,* 308 U. S. 252, and cases cited (p. 254). This conclusion is obviously correct, inasmuch as a lease—as distinct from the fee interest in lands—is of temporary value which decreases from year to year as the end of the term approaches.

Petitioners contend that these principles are inapplicable to them because they incurred no capital expense in procuring their leaseholds, and accordingly could obtain no allowance for depreciation. Even assuming this to be true,[2] it is immaterial, for the statute excludes from the definition of capital assets "property * * * *of a character* which is subject to the allowance for depreciation * * *." [Italics supplied.] The emphasis is upon the "character" of the property and not upon the right to any deductible allowance in the individual case. If the general character

[2] Only with respect to the Lincoln Theater, however, was there no cost basis. Claire Pekras had an admitted capital cost of $1,400 for attorneys' fees in acquiring the Capitol Theater lease (No. 840, R. 19, 23–24). In the acquisition of the leasehold she assumed and paid $11,934.72 of back rent due from Warner Bros., Inc., to Sadaris (No. 840, R. 18, 23). Assumption of that liability was a capital expenditure to acquire the lease and was subject to an allowance for depreciation. John Pekras also had a capital cost of $4,500 in acquiring certain outstanding adverse interests in connection with acquiring the Rivoli Theater lease (No. 840, R. 25).

of the property is of a depreciable nature it is excluded from the definition of a capital asset, and a leasehold is certainly of that general character.

The petitioners contend that in Ohio a leasehold creates an interest in real estate and that land is not subject to an allowance for depreciation. We agree that land is not subject to depreciation, but the petitioners were lessees and neither acquired nor sold any fee interest in the land as such. The fact that the Ohio courts regard a long-term lease as in many respects like the conveyance of a fee is not material, since the federal statute is controlling. *Weiss* v. *Wiener,* 279 U. S. 333, 337. Nor does the fact that in the selling agreements a separate value was ascribed to each lease and, in the case of the Capitol and Lincoln Theaters, a part for equipment and building rights, create a non-depreciable interest in land. It is the lease itself which is subject to depreciation. The petitioners are here confusing a fee interest in realty with a leasehold.

2. The petitioners argue that the Commissioner by his regulations has deliberately caused "taxpayer entrapment." This argument rests on the fact that a regulation issued under Section 23 (a), rather than under Section 23 (l), instructs a lessee that he may deduct annually over the period of his lease the proper proportion of the cost of erecting buildings or making permanent im-

provements, and states that such deduction "shall be in lieu of a deduction for depreciation."[3] But the integration in one regulation, for purposes of convenience, of the rules governing deductions for lessees[4] does not mean that the amount allowed is not "for the exhaustion, wear and tear of property" under Section 23 (l)—as it obviously is in fact. The only deductions under Section 23 (a) which could be applicable to this case are "business expenses" and "rent." But a lessee is also entitled to a deduction for cost spread over the term of the lease, and such exhaustion, as pointed out above, is the same as depreciation, the words being used as correlatives in Section 23 (l). The phrase "in lieu of a deduction for depreciation" was designed to make it clear that the taxpayer could not take two deductions for the same item of cost—one in the form of exhaustion and one in the form of depreciation (i. e., wear and tear) of the physical property. It is not to be construed—nor can it be in view of the plain language of Section 23 (a) and (l)—as denying to lessees the deduction defined in Section 23 (l); it merely describes the means of taking the deduction. See *Duffy* v. *Central R. Co.*, 268 U. S. 55.

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[3] The regulation is quoted in the Appendix, *infra*, pp. 13–14.

[4] Since rentals are deductible under Section 23 (a) but capital expenditures are not so deductible, and since leases involve both rentals and capital expenditures, it was appropriate to make the distinction in discussing rentals under Section 23 (a) in the regulations.

3. The conclusion of the Tax Court is not contrary to the stipulated facts or to the facts as found. The conclusion reached was that a leasehold is property of a character which is subject to exhaustion or depreciation allowed by Section 23 (l) and therefore is expressly excluded from classification as a capital asset. As pointed out above, it is immaterial that John Pekras has no cost for the lease of the Lincoln Theater.

CONCLUSION

The petition for writs of certiorari is without merit and should be denied.

Respectfully submitted.

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APPENDIX

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—

(1) *In General.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including * * * rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(l) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

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(26 U. S. C., Sec. 23.)

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) *Definitions.*—As used in this chapter—

(1) *Capital Assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable

year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23 (l);

* * * * *

(b) *Percentage Taken into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net income:

* * * * *

50 per centum if the capital asset has been held for more than 24 months.

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(26 U. S. C., Sec. 117.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.23 (a)-10. *Rentals.*—If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. The cost borne by a lessee in erecting buildings or making permanent improvements on ground of which he is lessee is held to be a capital investment and not deductible as a business expense. In order to return to such taxpayer his investment of capital, an annual deduction may be made from gross income

of an amount equal to the total cost of such improvements divided by the number of years remaining of the term of lease, and such deduction shall be in lieu of a deduction for depreciation. If the remainder of the term of lease is greater than the probable life of the buildings erected, or of the improvements made, this deduction shall take the form of an allowance for depreciation. (See Section 19.22 (a)–13.)

SEC. 19.117–1. *Meaning of terms.*—The term "capital assets" includes all classes of property not specifically excluded by section 117 (a) (1). In determining whether property is a "capital asset," the period for which held is immaterial.

The exclusion from the term "capital assets" of property used in the trade or business of a taxpayer of a character which is subject to the allowance for depreciation provided in section 23 (l) is limited to property used by the taxpayer in the trade or business at the time of the sale or exchange. * * *

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